Are Unicorns a Myth?

Unicorns are not just the stuff of fairy tales; some financia unicorns exist today. But investing in unicorns is speculative, and generally is unavailable to retail investors. Retail investors looking to bet on a unicorn may be able to do so indirectly through a mutual fund, exchange-traded fund or business development company. But beware; investing in unicorns is risky. This investment may bite.

What Does it Mean to be a Financial Unicorn?

In the area of financing businesses and start-up companies, the term "unicorn" has come to refer to a privately held company with a supposed valuation on paper of more than $1 billion. A privately held company is one that generally cannot sell shares to the public and is owned by a limited number of investors. Private companies can raise capital to fund their businesses in a variety of ways, and recent changes in federal and state securities laws have expanded these options.

Investors in unicorns typically are private funds (such as venture-capital, private equity or hedge funds), wealthy individuals, and direct owners or employees of the unicorn itself. SEC-registered mutual funds, exchange-traded funds (ETFs) and business development companies (BDCs) also may invest in unicorns.

Retail investors generally cannot purchase shares of unicorns directly, though. (Retail investors interested in betting on a particular unicorn could however search for a mutual fund, ETF or BDC with exposure to the company.) Investing in unicorns carries very real risks, however, particularly when investing directly into a unicorn. As privately held companies, there is no public market to trade the securities of unicorns.

This means that the securities are illiquid, or not easily sold or exchanged for cash. The market valuations of unicorns therefore may not reflect the intrinsic value of these businesses. Unicorns also are unlikely to have the same level of robust public disclosures required of publicly-traded companies.

Historically, investors in start-ups had limited opportunities to sell shares before the company held an IPO and a secondary trading market opened. Start-ups' securities accordingly were highly illiquid. Federal legislation that came into effect on December 4, 2015, though, eased the way for early investors to resell shares.1 This enabled unicorns to expand their investor base and develop market awareness prior to making a public offering (though unicorns should still be considered illiquid). In addition, regulatory changes enacted in 2012 raised the ceiling on the number of investors a private company could have before the company would be obligated to register its securities and become publicly traded. This regulatory change has helped unicorns stay private for longer periods of time.

What are Some Risks of Investing in pre-IPO Shares?

Fraud: weak internal controls and corporate governance infrastructure may lead to fraudulent practices by a unicorn. For example, a company could create false sales and shipping documents to artificially increase sales numbers. Disclosure: since the securities of unicorns will not be registered at the state or federal level, investors may lack important information to make an investment decision.

Liquidity: there is no guarantee shares can be resold after purchase.

Valuation: the valuation on a unicorn pre-IPO may not reflect the intrinsic value of the enterprise. In addition, even if the unicorn eventually holds an IPO, there is no guarantee the stock price will rise. Some IPOs are unsuccessful, and shares fall after the company goes public.

The Bottom Line:

Before making any decisions with your money, do your homework.

1 See The Reforming Access for Investments in Startup Enterprises ("RAISE") Act, enacted as Title LXXVI of the Fixing America's Surface Transportation Act ("FAST Act") of 2015.
2 See Title V of the Jumpstart Our Business Startups Act ("JOBS Act") of 2012. Specifically, Title V of the JOBS Act amended Section 12(g)(1) of the Securities Exchange Act of 1934, which sets a shareholder of record threshold beyond which private companies generally must register their securities with the U.S. Securities and Exchange Commission.

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614-644-7381 | com.ohio.gov/secu

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